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No. 93-404

In The

Supreme Court of the United States

October Term, 1993

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN
and FRANCIS I. BUTLER,

Petitioners,

vs.

ALLOYD CO., INC. and
WIND POINT PARTNERS II, L.P.,

Respondents.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Seventh Circuit

BRIEF OF AMICUS CURIAE NATIONAL ASSOCIATION OF SECURITIES AND COMMERCIAL LAW ATTORNEYS ("NASCAT") IN SUPPORT OF RESPONDENTS

JONATHAN W. CUNEO
General Counsel
NATIONAL ASSOCIATION OF SECURITIES AND COMMERCIAL LAW ATTORNEYS
317 Massachusetts Avenue, N.E.
Suite 300
Washington, D.C. 20002
Telephone: 202/789-3960

PATRICK E. CAFFERTY
(Counsel of Record)
MILLER FAUCHER CHERTOW CAFFERTY AND WEXLER
30 North LaSalle St.
Suite 3200
Chicago, IL 60602
Telephone: 312/782-4880

Attorneys for Amicus Curiae

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QUESTION PRESENTED

Whether Section 12(2) of the Securities Act of 1933 extends to a privately negotiated sale of stock.

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I. INTRODUCTION AND INTEREST OF AMICUS CURIAE

The National Association of Securities and Commercial Law Attorneys ("NASCAT") is an association of law firms and attorneys located throughout the United States. NASCAT and its members advocate the enactment and enforcement of effective laws to protect investors from deceptive and manipulative practices and to ensure that

the United States securities markets operate freely and efficiently. NASCAT's members frequently represent plaintiffs in a variety of individual, class action and derivative cases prosecuted under the federal securities laws. NASCAT and its members have an interest in the effective private enforcement of the federal securities laws and in developing case law that deters potential wrongdoers from perpetrating securities fraud violations upon investors in this country. This brief is filed with the written consent of the parties.

NASCAT and its members have an interest in this case because the Court's decision will affect the application of Section 12(2) of the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. § 77*l*(2), to secondary market transactions in publicly traded securities. Although the issue before the Court is framed in terms of Section 12(2)'s application to a privately negotiated sale of stock, the conflicting circuit court opinions directly affect Section 12(2)'s application to secondary market transactions. NASCAT is strongly opposed to the contention of Petitioners and their amici[1] that Section 12(2) be restricted to initial public offerings. Such a construction would require a disregard of the plain text of Section 12(2) and decades of practice.[2]

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[1] The Securities Industry Association, Inc. ("SIA") has filed an *amicus curiae* brief in support of Petitioners.

[2] In each of the following opinions, for example, the courts did not question the availability of section 12(2) to postdistribution trading: *Cady v. Murphy*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940); *Woodward v. Wright*, 266 F.2d 108, 116 (10th Cir. 1959); *Franklin Sav. Bank v. Levy*, 551 F.2d 521 (2d Cir. 1977); *Yancoski v. E.F. Hutton & Co.*, 581 F. Supp. 88, 93 (E.D. Pa. 1983);

The Third Circuit was the first circuit court to expressly consider the issue. In *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir. 1991), *cert. denied*, ___ U.S. ___, 112 S. Ct. 79, 116 L. Ed. 2d 52 (1991), the court concluded that Section 12(2)'s application was limited to primary distributions. However, in *Pacific Dunlop Holdings, Inc. v. Allen & Co., Inc.*, 993 F.2d 578 (7th Cir. 1993), *cert. granted*, ___ U.S. ___, 114 S. Ct. 907, 127 L. Ed. 2d 98, *cert. dismissed*, ___ U.S. ___, 114 S. Ct. 1146, 127 L. Ed. 2d 454 (1994), the Seventh Circuit reached the opposite result, finding that the textual clarity and corresponding legislative history of Section 12(2) demonstrated its application to all sales of securities.[3] In the case before the Court, the Seventh Circuit vacated a grant of summary judgment in favor of defendants and remanded for reconsideration in light of *Pacific Dunlop*. After the writ of certiorari in *Pacific Dunlop* was dismissed, this Court granted the petition for a writ of certiorari here. *Gustafson v. Alloyd Co.*, ___ U.S. ___, 114 S. Ct. 1215, 127 L. Ed. 2d 562 (1994).

Carrott v. Shearson Hayden Stone, Inc., 724 F.2d 821 (9th Cir. 1984); *Roger v. Leaman Bros. Kuhn Loeb, Inc.*, 604 F. Supp. 222, 224 (S.D. Ohio 1984); *Monetary Management of St. Louis, Inc. v. Kidder Peabody & Co.*, 615 F. Supp. 1217, 1219-1223 (E.D. Mo. 1985); *Quincy Co-op Bank v. A.G.Edwards & Sons, Inc.*, 655 F. Supp. 78, 84 (D. Mass. 1986); *Short v. Belleville Shoe Mfg. Co.*, 908 F.2d 1385, 1390 (7th Cir. 1990) (dicta), *cert. denied*, ___ U.S. ___, 111 S. Ct. 2887, 115 L. Ed. 2d 1052 (1991).

[3] In *First Union Discount Brokerage Serv. v. Milos*, 997 F.2d 835, 843-844 (11th Cir. 1993), the Eleventh Circuit followed *Ballay* without expanding on its reasoning.

NASCAT, as *amicus curiae*, respectfully submits that the Seventh Circuit's order in this case, following its thoughtful decision in *Pacific Dunlop*, should be affirmed and that this Court should specifically hold that the express right of action under Section 12(2) is not limited to initial public offerings.

II. SUMMARY OF ARGUMENT

The issue before the Court is whether Section 12(2) "extends to a privately negotiated sale of stock." Intertwined with this issue is whether or not Section 12(2) applies to any purchase of a security other than through an initial public offering. By its plain language, Section 12(2) also protects purchasers in private transactions and purchasers on secondary markets.[4] Since the overwhelming majority of transactions in securities are on secondary markets, it is difficult to imagine that the drafters of Section 12(2) would exclude these transactions from coverage without express language.[5] *See Wilko v. Swan*, 127 F. Supp. 55, 59 (S.D.N.Y. 1955) ("Nothing in the [1933] Act reflects a more tender regard for the dishonest trader, nor a purpose to protect only purchasers defrauded by sellers other than traders."). It is also inconceivable that Congress intended to exclude Section 12(2)'s application to private securities transactions, when it expressly exempted such transactions only from the registration requirements of the 1933 Act. *See* 15 U.S.C. § 77d(2).

This Court should hold that Section 12(2) applies, as the statute reads, to any person who "offers or sells a security", whether it is publicly traded or not. The plain language of the statute, including a broad definition of the terms "security" and "prospectus",[6] do not restrict Section 12(2)'s application to initial public offerings. *See infra* § III.A.

Related provisions of the 1933 Act support a broad reading of Section 12(2). Section 4(2), 15 U.S.C. § 77d(2), exempts private securities transactions from the Act's registration requirements, but not the antifraud provisions. *See infra* § III.B.1. Section 13, 15 U.S.C. § 77m, provides a three-year period of repose that commences with "the sale" (as opposed to the date "bona fide offered to the public" as used for Sections 11 and 12(1)[7]), thereby demonstrating application to transactions other than initial public offerings. *See infra* § III.B.2. In addition, the language of Section 12(2) is similar in scope to Section 17(a), 15 U.S.C. § 77q(a), which, as this Court has held,

[4] Section 12(2) is an important remedy for abusive sales practices utilized in secondary markets. *See, e.g., Farley v. Baird, Patrick & Co.* 750 F. Supp. 1209 (S.D.N.Y. 1990); *Hoxworth v. Blinder Robinson & Co.*, 1989 WL 56113, 1989 U.S. Dist LEXIS 5729 (E.D. Pa. May 23, 1989), *vacated on other grounds*, 903 F.2d 186 (3d Cir. 1990).

[5] *See* Louis Loss, Comment, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev., 908, 916 (1992) ("[I]t is almost inconceivable that these two great statutes [*i.e.*, the 1933 Act and the 1934 Act] – which repeatedly have been treated as *in pari materia* – were meant to afford no civil remedy whatsoever to the great bulk of investors who do not participate in distributions." [footnote omitted.]).

[6] 15 U.S.C. § 77b(1), (10).

[7] 15 U.S.C. §§ 77k, 77*l*(1).

applies to postdistribution transactions. *United States v. Naftalin*, 441 U.S. 768, 778 (1979). *See infra* § III.B.3.

Interpreting Section 12(2) in light of the implied right of action under Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 77j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, does not support a restrictive interpretation of Section 12(2), as the *Ballay* Court erroneously held. A comparison of these causes of action is ahistorical and in no way demonstrative of a legislative intent to limit Section 12(2) to primary markets. *See infra* § III.C.

Finally, the available legislative history, if considered, demonstrates that Section 12(2) was intended to apply to all transactions in securities. *See infra* § III.D.

III. ARGUMENT

A. SECTION 12(2), BY ITS PLAIN LANGUAGE, APPLIES TO ALL SALES OF SECURITIES.

To interpret Section 12(2), the Court must look first to the express language of the statute. If the language of the statute is clear, that is the end of the matter. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, ___ U.S. ___, 114 S. Ct. 1439, 1446, 128 L. Ed. 2d 119 (1994); *Good Samaritan Hospital v. Shalala*, ___ U.S. ___, 113 S. Ct. 2151, 2157, 124 L. Ed. 2d 368 (1993). The Court must enforce the unambiguous language in the absence of a clearly expressed legislative intent to the contrary. *Reves v. Ernst & Young*, ___ U.S. ___, 113 S. Ct. 1163, 1169, 122 L. Ed. 2d 525 (1993); *United States v. Turkette*, 452 U.S. 576,

580 (1981).[8] Section 12(2), the text of which is set out in the footnote below, provides for a cause of action with the following elements:[9]

1. Defendant offered or sold "a security";
2. By the use of any means of communication in interstate commerce;
3. Through a "prospectus" (defined to include notice, circular, advertisement, letter, or communication[10]) or oral communication;
4. By making a false or misleading statement of material fact necessary in order to make

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[8] In *Randall v. Loftsgaarden*, 478 U.S. 647, 656 (1986) this Court found that the remedy analysis of Section 12(2) "speaks with the clarity necessary to invoke this 'plain meaning' canon." *See Pacific Dunlop*, 993 F.2d at 589.

[9] Section 12(2) (15 U.S.C. § 77*l*(2)), provides that "[a]ny person who – * * * offers or sells a security (whether or not exempted by the provisions of [Section 3], other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."

[10] 15 U.S.C. § 77b(10).

the statements, in light of the circumstances under which they were made, not misleading;[11]

5. Plaintiff did not know of the untruth or the omission; and

6. Defendant knew, or in the exercise of reasonable care, could have known of the untruth or omission.

See Monetary Management Group, Inc. v. Kidder, Peabody & Co., 615 F. Supp. 1217, 1222 (D.C. Mo. 1985); *Darrah-Wantz v. Brown*, 138 F.R.D. 20, 23-24 (D. Conn. 1991).[12]

The purpose and effect of Section 12(2) is unambiguous – *i.e.*, as between a purchaser and a seller, the seller will bear the consequences of a false statement or omission of material fact, be it oral or written, unless the seller can demonstrate that he or she was not at fault. *See Quincy Co-op Bank v. A.G. Edwards & Sons, Inc.*, 655 F. Supp. 78, 84 (D. Mass. 1986). The rescissory damage remedy could include recovery of losses unrelated to the misstatement or omission, such as market losses incurred after the transaction. *See Randall v. Loftsgaarden*, 478 U.S. 647, 659 (1986) ("Congress shifted the risk of an intervening decline in the value of the security to defendants,

[11] A material fact exits, under the federal securities laws, when there is a substantial likelihood that a reasonable investor would consider the fact important enough to alter the "total mix" of information available. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 231-232 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[12] *See also* Theresa H. Maynard, *Liability under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Postdistribution Markets*, 32 Wm. & Mary L. Rev. 847, 851 (1991).

whether or not that decline was actually caused by the fraud."); *Hoxworth v. Blinder Robinson & Co.*, 903 F.2d 186, 203 n.25 (3d Cir. 1990).[13]

As Section 12(2) applies to any person who offers or sells "a security," the question concerning the scope of its application is readily answered by the definition of the term "security". Section 2(1) of the 1933 Act, 15 U.S.C. § 77b(1), defines "security" broadly, including "any note, stock, treasury stock, bond" among numerous others. Whether or not an investment even meets the requirements of a "security" under the 1933 Act may be a question of fact. *See Sec. & Exch. Comm'n. v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946) (The definition of "security" in the 1933 Act embodies "a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."); *see also Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985). It is beyond dispute that closely held stock and stock traded on secondary markets fit easily within the definition of "security." Congress would not have defined "security" broadly had it intended the term, as applied in Section 12(2) without qualification, to cover only stocks in initial public offerings.[14]

[13] Section 12(2) is a legislative modification of common law deceit with an element of equitable rescission. *See* Loss, Comment, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev., 908, 910 (1992); IX Loss & Seligman, *Securities Regulation* 4199-4207 (3d ed. 1992).

[14] It is the offer or sale of a "security" defined by Section 2(1) that triggers the application of Section 12(2). Thus, the question should be "Is it a security?" not "What kind of security

1. The Broad Definition of "Prospectus" in the 1933 Act is Unambiguous.

The linchpin of *Ballay*'s reasoning is that the term "prospectus" in Section 12(2) evinces Congress' intention to limit its application to the initial public offering. The court in *Ballay* indicated that if it "had intended an expansive meaning for the term 'prospectus', Congress more simply could have drafted section 12(2) to describe all 'written and oral communications'." 925 F.2d 689. Contrary to the *Ballay* Court's argument, Congress did just that. The definition of "prospectus" in Section 2(10) "essentially states that any written offer constitutes a prospectus". IX Louis Loss & Joel Seligman, *Securities Regulation* 4220 (3d ed. 1992). Section 2(10) defines "prospectus" as including any "notice, circular, advertisement, letter, or communication."

Instead of the definition set out in Section 2(10), *Ballay* adopted a much more restricted definition of "prospectus" from Section 10 of the 1933 Act, 15 U.S.C. § 77j, which specifies the contents of a "prospectus." The *Ballay* Court concluded that a "prospectus" for purposes of Section 12(2) must mean a document which meets the requirements of Section 10. 925 F.2d at 688-689. However,

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is it?" Here, the application of Section 12(2) can be established by the following syllogism: Section 12(2) applies to the offer and sale of "a security." The stock of Alloyd Company constitutes "a security." 15 U.S.C. § 77b(1) ("stock"). Therefore, Section 12(2) applies to the offer and sale of stock of Alloyd Company. As Professor Loss has stated, "all one needs to do here is to *read the words* in the relevant provisions." Loss, Comment, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev., 908, 917 (1992) (footnoted omitted; emphasis in original).

a "prospectus" that meets the requirements of Section 10 is merely a sub-group of the larger group of written communications falling under Section 2(10)'s definition of "prospectus" and not a substitute for the general definition provided by Congress. *PPM America, Inc. v. Marriott Corp.*, 820 F. Supp. 970, 977 (D. Md. 1993).

Section 10 requires that a "prospectus" contain, for the most part, the information set forth in the registration statement required by Section 5 of the 1933 Act. 15 U.S.C. § 77e. The requirements of Section 10 are enforced through Section 5, which provides that it is unlawful to "carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under [the 1933 Act], unless such prospectus meets the requirements of section 10". 15 U.S.C. § 77e(b)(1). A "prospectus" must therefore meet the requirements of Section 10 "only if the prospectus relates to a security for which a registration statement has been filed." *PPM America, Inc. v. Marriott Corp.*, 820 F. Supp. 970, 977 (D. Md. 1993). A registration statement need not be filed every time a security is offered or sold. *See* Sections 3 and 4 of the 1933 Act, 15 U.S.C. §§ 77c and 77d (exempting a significant number of securities and transactions from Section 5 registration). Thus, a Section 10 prospectus is required for some, but not all, "securities" as defined by the 1933 Act. *See* 15 U.S.C. § 77b(1).

In sharp contrast to Section 10, Section 12(2) applies to *all* securities transactions, including those subject to Section 3 and Section 4 exemptions. *See Woodward v. Wright*, 266 F.2d 108, 116 (10th Cir. 1959) (Section 12(2) applies to securities "whether exempt from registration

or not".); II Loss & Seligman, *Securities Regulation* 906-907 (3d ed. 1992) ("[T]he exemptions generally do not apply to the antifraud provisions of §§ 12(2) and 17."). In *Sec. Indus. Assoc. v. Bd. of Governors of the Fed. Reserve Sys.*, 468 U.S. 137, 151 (1984), for example, this Court noted that rather than amend the definition of "security" in the 1933 Act to exclude commercial paper, "Congress chose instead to exempt commercial paper only from the registration requirements of the statute, see 15 U.S.C. § 77c(a)(3), while preserving application of the statute's antifraud provisions to all commercial-paper 'securities.' §§ 77l, 77q(c)." (footnote omitted.) *See* 15 U.S.C. § 77b(1). Therefore, *Ballay* erroneously limited Section 12(2) coverage to only those situations where Section 10 applies.

This Court has noted that "[w]hen a word is not defined by statute, we normally construe it in accord with its ordinary or natural meaning." *Smith v. United States*, ___ U.S. ___, 113 S. Ct. 2050, 2054, 124 L. Ed. 2d 138 (1993). When a word *is* defined by the statute, of course, it must be construed according to the definition. The definition of "prospectus" in Section 2(10), not the more limited use of the term in Section 10, applies to Section 12(2). Congress' definition simply cannot be ignored. *See Pacific Dunlop* 993 F.2d at 586 (*Ballay*'s "approach would result in an entirely new definition in place of section 2(10).").

2. The Available Measure of Damages Under Section 12(2) is not Inconsistent with Secondary Market Trading.

The *Ballay* Court also found that the remedies available under Section 12(2) (*i.e.* rescission or rescissory

damages) logically applied to initial distributions but not to the secondary market, thereby evincing Congress' intent to limit Section 12(2) to distributions.

> These sellers [*i.e.* distribution] receive the full purchase price from the investors and are the investors' sole source of information concerning the value of the security. The same is not true in the aftermarket, such as Legg Mason, who receive only a commission and who are not the investors' sole source of information concerning the value of the stock.

925 F.2d at 693.

Ballay's reasoning is inapposite because Congress did not provide for a rescission in Section 12 because of the logic of applying it to sellers. "Congress chose rescission for its *effects*". *Pinter v. Dahl*, 486 U.S. 622, 647-48 n.23 (1988) (emphasis added). This measure of damages was selected "in part because of the additional measure of deterrence provided by rescission as compared to a purely compensatory measure of damages." *Id.*; *see also Randall v. Loftsgaarden*, 478 U.S. 647, 659 (1986). In addition, in keeping with the powerful deterrent effect of rescission or rescissory damages, "the risk of its invocation should be felt by *solicitors* of purchasers." *Pinter*, 486 U.S. at 646 (emphasis added); *see also Commercial Union Assurance Co., PLC v. Milken*, 17 F.3d 608, 616 (2d Cir. 1994). Thus, a "seller" under Section 12(2) is defined far more broadly than the person who actually transfers title and receives payment. *See infra* § III.C. If a rescissory remedy is available against these "sellers" at the initial offering, nothing is amiss with such a remedy in the

secondary market.[15] Indeed, a seller in the secondary market (as opposed to the issuer in a public offering) could well receive the full purchase price from the investor.[16]

In sum, Section 12(2), by its plain language, applies to all transactions in securities.

B. CONSIDERATION OF SECTION 12(2) IN CONJUNCTION WITH OTHER PROVISIONS OF THE 1933 ACT SUPPORTS A BROAD INTERPRETATION OF THE STATUTE.

Section 12(2)'s application to all securities transactions is supported by a consideration of similar and related provisions in the 1933 Act, specifically Sections 4(2), 13 and 17(a). 15 U.S.C. §§ 77d(2), 77m, 77q(a).

1. Section 12(2) Applies to Private Securities Transactions.

The 1933 Act includes a "private offer" exemption in Section 4(2), 15 U.S.C. § 77d(2). It provides that the registration requirements of Section 5, 15 U.S.C. § 77e, "shall

[15] In *Ballay*, had Legg Mason received only a commission on an initial offering, its liability under Section 12(2) would be beyond dispute. In fact, the broker's commission itself is an element of the damages. *See Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269, 276 (10th Cir. 1957) (plaintiff is entitled to restoration of entire purchase price).

[16] "[T]here can be a 'security' without an 'issuer,' the definition of the latter term being important only because the 'issuer' must sign a registration statement under § 6 [15 U.S.C. § 77f] and is absolutely liable for material defects in it under § 11. By contrast, §§ 12 and 17(a) refer to any 'person' who sells." II Loss & Seligman, *Securities Regulation* 908 (3d ed. 1992).

not apply to . . . transactions by an issuer not involving any public offering." The private offer exemption relates only to the registration requirements of Section 5 and does not exempt a transaction from the antifraud provision of Section 12(2). *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 692 (1985) ("[A]lthough § 4(2) of the 1933 Act exempts transactions not involving any public offering from the Act's registration provisions, there is no comparable exemption from the antifraud provisions."); *Pacific Dunlop*, 993 F.2d at 587. *See also Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093, 1099 (5th Cir. 1973), *cert. denied*, 415 U.S. 977 (1974); *Haralson v. E.F. Hutton Group, Inc.*, 919 F.2d 1014, 1032 (5th Cir. 1990). The fact that Congress chose to exempt private securities transactions from registration, but not from the antifraud provisions, demonstrates a deliberate congressional choice with which the courts should not interfere. *Cf. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. at 1452 ("The fact that Congress chose to impose some forms of secondary liability, but not others, indicates a deliberate congressional choice with which the courts should not interfere.").

2. The Statute of Limitations for Section 12(2) Commences with "the Sale" as Opposed to the Date "Bona Fide Offered to the Public."

The statute of limitations and period of repose for the private rights of action under Sections 11, 12(1) and 12(2), 15 U.S.C. §§ 77k, 77*l*, are set forth in Section 13 of the 1933 Act. 15 U.S.C. § 77m. Section 13 makes an unmistakable distinction between the causes of action in Sections 11 and 12(1), on the one hand, and Section 12(2) on the

other. Section 11 and 12(1) both involve liability related to registration statements required by Section 5 – Section 11 for a false registration statement and Section 12(1) for not submitting a required registration statement. The period of repose for Sections 11 and 12(1) commences when the stock is "bona fide offered to the public", which recognizes that truly private securities transactions cannot result in liability because of the exemption from registration in Section 4(2). *See also Pacific Dunlop*, 993 F.2d at 585-586 n.12. Section 12(2), however, applies to "[a]ny person who . . . offers or sells a security" and the period of repose necessarily commences with "the sale". 15 U.S.C. § 77m. There is no mention of an offer to the public, because (unlike Sections 11 and 12(1)) an offer to the public is not required to violate Section 12(2), only an offer or sale of "a security" based on material misstatements or omissions.[17]

Had Congress intended to restrict Section 12(2) to initial public offerings, its period of repose would logically have also commenced with the bona fide offering to the public. By commencing the period with the sale, however, Congress expressly envisioned a far wider application. This Court should therefore reject Petitioners' invitation upset Congress' carefully balanced language in Sections 4, 5, 11, 12(1), 12(2) and 13 by restricting Section 12(2)'s application to initial public offerings.

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[17] *See* II Loss & Seligman, *Securities Regulation* 908 (3d ed. 1992), quoted in the previous footnote.

Ballay found that the placement of Section 12(2) – *i.e.* after Sections 11 and 12(1) and before Section 13 – was demonstrative of an intent to limit its application to initial offerings because "[a]ll of these sections deal with initial distributions." 925 F.2d at 691. This "structure" contention was properly rejected by the Seventh Circuit in *Pacific Dunlop*, 993 F.2d at 585-586; *see also PPM America, Inc.*, 820 F. Supp. at 978 ("That reasoning is based on little more than the location of § 12(2) in the 1933 Act and ignores other provisions of the Act which reveal its true structure."). It is also wrong in its premise because, as it relates to Section 12(2), Section 13 does not "deal with initial distributions." 925 F.2d at 691. Thus, the *Ballay* Court's attempt to glean legislative intent from the "structure" of the 1933 Act simply does not support a restrictive reading of Section 12(2).

3. The Application of Section 17(a) of the 1933 Act to the Secondary Markets Supports a Similar Application of Section 12(2).

It is also worth considering Section 17(a) of the 1933 Act, which criminalizes certain fraudulent practices by "any person in the offer or sale of securities." 15 U.S.C. § 77q(a). Section 12(2) is, in many respects, the civil liability analogue to Section 17(a). IX Loss & Seligman, *Securities Regulation* 4219 (3d ed. 1992). Neither Section 17(a) nor Section 12(2) makes a distinction between initial distributions and secondary market trading. *See Barnes v. Osofsky*, 373 F.2d 269, 272 (2d Cir. 1967) ("In contrast [to § 11] both §§ 12(2) and 17, the antifraud sections of the 1933 Act, . . . are not limited to the newly registered securities."). This Court held that "[u]nlike much of the

rest of the [1933] Act, [Section 17(a)] was intended to cover any fraudulent scheme in the offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading." *United States v. Naftalin*, 441 U.S. 768, 778 (1979). The Court's construction of Section 17(a) plainly extends to Section 12(2). *See* Loss, Comment, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev., 908, 915-916 (1992).

In an effort to distinguish *Naftalin*, the court in *Ballay* found that Section 12(2) was drawn more narrowly than Section 17(a).

> The plain words, "directly or indirectly" and "*any* device" of section 17(a) differ from the specific "prospectus or oral communication" language of section 12(2). Had Congress intended section 12(2) to extend to liability for secondary transactions, it could have preceded "oral communications" with "any" and explicitly stated its special intent in legislative history.

925 F.2d at 692 (emphasis added by court). The *Ballay* Court's analysis ignores the plain wording of Section 12(2), which is substantially similar to Section 17(a) in terms of its scope. Section 17(a) applies to "any person in the offer or sale of any securities", 15 U.S.C. § 77q(a), while Section 12(2) applies to "[a]ny person who . . . offers or sells a security", 15 U.S.C. § 77*l*(2). Section 12(2)'s reference to "a security" in the singular, and Section 17(a)'s reference to "any securities" in the plural, is a mere difference in draftsmanship that does not carry substantive implications. *See* 15 U.S.C. § 77b(1).

While the 1933 Act was, no doubt, primarily concerned with the regulation of new offerings, Section 17(a)

was not the only departure from that purpose; Section 12(2) is another departure. *Naftalin* holds that, absent specific language to the contrary, the 1933 Act is not restricted to initial offerings. *See Pacific Dunlop*, 993 F.2d at 593 ("[N]othing in the Supreme Court's reasoning in *Naftalin* directs that a broad reading of section 17 dictates a narrow reading on the remainder of the 1933 Act."). The Court's reasoning in *Naftalin*, therefore, strongly supports Section 12(2)'s application to secondary markets.

C. THE OVERLAP BETWEEN SECTION 12(2) AND SECTION 10(b) OF THE 1934 ACT IS "NEITHER UNUSUAL NOR UNFORTUNATE."

On some facts, Section 12(2) and Section 10(b) provide concurrent causes of action.[18] As both *Ballay* and *Pacific Dunlop* properly noted, the 1933 and 1934 Acts should be construed as *in pari materia*, that is, as coordinating statutes which contain some overlapping provisions. This Court has reaffirmed that " 'the fact that there may well be some overlap [between the two Acts] is neither unusual nor unfortunate.' " *Herman & MacLean v. Huddleston*, 459 U.S. 375, 383 (1983), quoting *United States v. Naftalin*, 441 U.S. 768, 778 (1979).

Nevertheless, *Ballay* found that a postdistribution cause of action under Section 12(2) would render purchaser actions under Section 10(b) "superfluous." 925 F.2d at 692-693 & n. 13. The court reasoned that plaintiffs would never have reason to sue under Section 10(b), since

[18] *See, e.g., Carrott v. Shearson Hayden Stone, Inc.*, 724 F.2d 821 (9th Cir. 1984).

they could receive a better remedy while enjoying a much more relaxed burden of proof under Section 12(2). 925 F.2d at 692-93. Section 12(2), unlike Section 10(b), requires no proof of scienter, or reliance, and embodies a more relaxed standard of causation. "If it were determined that section 12(2) applied to secondary market trading, the more lenient requirements of section 12(2) would effectively eliminate the use of section 10(b) by securities purchasers. Such a construction would overrule, *sub silentio*, section 10(b) as a remedy for purchasers." 925 F.2d at 692-693 (footnote omitted).[19]

As a matter of both practice and statutory construction, the *Ballay* Court's analysis is specious. Congress adopted Section 10(b) of the 1934 Act "as a nonself-executing, catchall fraud prophylactic" in case the more specific antifraud provisions "proved to be no match for the ingenuity of the securities community." IX Loss &

[19] Section 12(2) does not necessarily provide a better remedy, assuming a choice of remedies is available. In *Randall*, this Court reserved the issue of whether a rescissory measure of damages may be appropriate for defrauded buyers under Rule 10b-5. 478 U.S. at 661-662. While some courts have rejected this remedy under Rule 10b-5, *see Sharp v. Coopers & Lybrand*, 649 F.2d 175, 190 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982), others have approved rescissory remedies on certain facts. *See Bruschi v. Brown*, 876 F.2d 1526, 1532 (11th Cir. 1989); *Gordon v. Burr*, 506 F.2d 1080, 1085 (2d Cir. 1974). In addition, one who purchased a security that has *increased* in value certainly would not want a rescissory remedy, rendering Section 12(2) – but not Section 10(b) – inapplicable. *Cf. Rand v. Monsanto Co.*, 926 F.2d 596, 600 (7th Cir. 1991) (that investor eventually made a profit on a stock "does not disqualify him from recovering any loss attributable to the concealment of material information that Monsanto had a duty to disclose.").

Seligman, *Securities Regulation* 4219-4220 (3d ed. 1992). A "catchall" need not be an exclusive remedy; overlap on certain facts with other causes of action is inevitable.[20]

To begin with, interpreting Congress' intent when adopting Section 12(2) in light of the cause of action that has evolved under Rule 10b-5 is unfounded because Rule 10b-5 simply did not exist at the time of Section 12(2)'s enactment. "[A] comparison of these two sections is ahistorical and is not useful in interpreting the meaning of 12(2)." *PPM America, Inc. v. Marriott Corp.*, 820 F. Supp. 970, 976 (D. Md. 1993). As Professor Loss has stated:

> No one could have anticipated in 1934 that rule 10b-5 would be adopted eight years later, let alone that the courts would imply a private right of action for its violation (hence rendering it the primary vehicle for private litigation under the federal securities laws).

Loss, Comment, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev., 908, 915-916 (1992). Rule 10b-5, therefore, cannot be used as a pretext for the judicial pruning of the express right of action under Section 12(2).

In addition, *Ballay*'s conclusion that Rule 10b-5 actions would be rendered "superfluous" failed to address key distinctions between Section 10(b) and Section 12(2). Most importantly, Section 12(2) applies only to "sellers," while Section 10(b) reaches a wider range of participants.

[20] It is beyond dispute that Section 10(b) overlaps Section 12(2) with respect to fraud in the primary market; nothing in the statute makes such an overlap on secondary markets transactions impermissible.

The broadly defined statutory terms "offer" and "sell" in Section 12(2) are "expansive enough to encompass the entire selling process, including the seller/agent transaction." *Pinter v. Dahl*, 486 U.S. 622, 643 (1988) (quoting *Naftalin*, 441 U.S. at 773).[21] *See also* IX Loss & Seligman, *Securities Regulation* 4227 (3d ed. 1992). Those who participate in a scheme to defraud but who remain completely outside of the actual purchaser-seller transaction might escape liability under Section 12(2). *Pinter* was concerned with reaching persons such as brokers who might act on the seller's behalf for profit. *See Pinter*, 486 U.S. at 654-655; *Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1126 (2d Cir. 1989).[22] Numerous

[21] While *Pinter* dealt with Section 12(1), 15 U.S.C. § 77*l*(1), courts that have considered the question have applied the *Pinter* standard of "seller" to Section 12(2). *See Ryder Int'l Corp. v. First American Nat'l Bank*, 943 F.2d 1521, 1528 n. 11 (11th Cir. 1991).

[22] Indeed, the most vulnerable targets of Section 12(2) actions in the secondary market, as in *Ballay*, are brokers who profit by recommending and selling a particular security to their customers with false information. According to the SIA, innocent securities investors should bear the consequences of the *seller's* malfeasance because it would purportedly place too great a burden on securities sellers. (SIA Brief at 18-24.) Imposing a duty to exercise reasonable care, however, cannot be construed as burdensome. A securities broker

> cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation, he implies that a reasonable investigation has been made and that his recommendation rests on conclusions based on such investigations.

Sec. & Exch. Comm'n v. Hasho, 784 F. Supp. 1059, 1107 (S.D.N.Y. 1992), quoting from *Hanly v. Sec. & Exch. Comm'n*, 415 F.2d 589, 597 (2d Cir. 1969). *See also Sec. & Exch. Comm'n v. Great Lakes Equities, Co.* [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,685 at 98,206 (E.D. Mich. Sept. 4, 1990), *aff'd*, 12 F.3d 214 (6th Cir. 1993). Without a secondary market cause of action under 12(2), securities investors have no means under the federal securities laws to enforce this clear duty imposed on securities brokers. Certainly more due diligence is required for an initial public offering (SIA Brief at 19-20), but that is no reason to excuse reasonable care in the secondary market.

courts have ruled that attorneys and accountants and others who remain outside of the sales process are not "sellers" under Section 12.[23] Rule 10b-5, on the other hand, proscribes all fraudulent conduct "in connection with" the purchase or sale of a security. While there must be a purchase or a sale of a security, violation of Rule 10b-5 is not limited to those involved in the sales process itself. The plaintiff in a Rule 10b-5 case need only establish that the defendant's fraud "touched" on the purchase or sale of a security. *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971); *Rudolph v. Arthur Andersen*

[23] *See, e.g., Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1126-1127 (2d Cir. 1989) (attorney); *Moore v. Kayport Package Express, Inc.*, 885 F.2d 531, 537 (9th Cir. 1989) (attorney and accountant); *Royal Am. Managers, Inc. v. IRC Holding Corp.*, 885 F.2d 1011, 1017 (2d Cir. 1989) (attorney and director); *Ackerman v. Schwartz*, 947 F.2d 841, 845 (7th Cir. 1991) (attorney); *In re Crazy Eddie Sec. Lit.*, 714 F. Supp. 1285, 1293-1294 (E.D.N.Y. 1989) (accountant); *Loan v. Fed. Deposit Ins. Corp.*, 717 F. Supp. 964, 968 (D. Mass. 1989) (officers and directors); *Buford White Lumber Co. Profit Sharing & Sav. Plan & Trust v. Octagon Properties, Ltd.*, 740 F. Supp. 1553, 1558 (W.D. Okla. 1989) (law firm); *Zupnick v. Thompson Parking Partners*, [1990 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 95,388 at 96,912-13 (S.D.N.Y. 1990) (accountants), *appeal dismissed*, 989 F.2d 93 (2d Cir. 1993); *Sellin v. RX Plus, Inc.* 730 F. Supp. 1289, 1291-1294 (S.D.N.Y.1990) (attorney).

& Co., 800 F.2d 1040, 1046 (11th Cir. 1986), *cert. denied*, 480 U.S. 946 (1987). As this Court recently stated in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, ___ U.S. ___, 114 S. Ct. 1439, 1455, 128 L. Ed. 2d 119 (1994), "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming ail of the requirements for primary liability under Rule 10b-5 are met." Section 10(b), therefore, reaches numerous potential defendants who are not "sellers" in the Section 12 sense.[24] The suggestion that the secondary market cause of action under Section 12(2) renders Rule 10b-5 actions "superfluous" is therefore without merit.

D. THE PURPOSE AND EFFECT OF THE SECURITIES ACT OF 1933 SUPPORTS THE APPLICATION OF SECTION 12(2) TO SECONDARY MARKET TRADING.

Because the language of the statute is clear, this Court need not delve into the legislative history of the 1933 Act to determine the drafters' intent. Congress applied Section 12(2) to "[a]ny person who . . . offers or

[24] In a Rule 10b-5 "fraud-on-the-market" case, for example, the "seller" may not be responsible for misconduct that wrongfully inflates the market price of a security. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 244 (1988) (" 'The market is interposed between the seller and buyer and, ideally, transmits information to the investor in the processed form of a market price.' ") (citation omitted).

sells a security" and this Court "must presume that Congress meant what it said." *Pinter*, 486 U.S. at 653. The unambiguous language of a statute can be the subject of an inquiry into legislative intent only when a contrary intention is "clearly expressed." *Reves v. Ernst & Young*, ___ U.S. ___, 113 S. Ct. 1163, 1169, 122 L. Ed. 2d 525 (1993). In both *Ballay* and *Pacific Dunlop*, the circuit courts considered legislative history and reached opposite conclusions. *See also Randall*, 478 U.S. at 657 (noting that the legislative history of Section 12(2) is "sparse"). Therefore, a *clearly* expressed legislative intent contrary to a broad interpretation of the statute is patently not available.

If legislative history is considered, the Seventh Circuit's analysis focusing on key distinctions between House and Senate drafts of the legislation soundly demonstrates that the language of Section 12(2) was intended to apply to both primary and secondary markets. *Pacific Dunlop*, 993 F.2d at 589-592. In contrast, *Ballay* relied upon a House Report accompanying the 1933 Act that noted that the bill "affects only new offerings of securities . . . [and] does not affect the ordinary redistribution of securities . . . " 925 F.2d at 690 (quoting H.R. No. 85, 73d Cong., 1st Sess. 7 (1933)). This general statement, directed to a draft of the 1933 Act as a whole, cannot be construed as specifically limiting the application of Section 12(2) – or for that matter Section 17(a) – to primary distributions. No one disputes that the 1933 Act was *primarily* concerned with initial distributions, *see Naftalin*, 441 U.S. at 778, but there are express exceptions which even *Ballay* recognized relative to Section 17(a). 925 F.2d at 692. Section 12(2), by its plain language, is another exception, the impact of which cannot be negated by

sweeping general statements addressed to the 1933 Act as a whole.

The SIA focuses on comments of various legislators in the House to the effect that secondary market abuses were not addressed by the House bill. (SIA Brief at 15-16.). The House bill, however, did not become law. *See Pacific Dunlop*, 993 F.2d at 592. Senate Bill 875 replaced the House bill and the pertinent language was changed to "any security." May 8, 1933, 77 Cong. Rec. 2996-3000 (1933) (contained in section 9 of the Senate version). Senator Norbeck's comments regarding the New York Stock Exchange do not indicate an intention to limit Section 12(2) to initial public offerings. (*See* SIA Brief at 17.) The Senator, addressing violations of rules by members of the New York Stock Exchange, stated that

> Their rules seemed to be aimed toward providing for what they consider square dealing between members of the exchange and to make sure of the solvency of members so that their obligations will not be unpaid. While strict rules have prevailed as to the conduct of members toward each other, only recently have they discovered that the public is also a party to stock-market transactions and has interests which should be protected. *It seems to be a new idea to think first of protecting the investor in the stock market. Until recently they had been operating under the idea that the "buyer should beware", but this bill proposes to place responsibility on the one who sells.*
>
> The pending bill does not in any way deal with the stock exchange. That matter has been left for subsequent and much-needed legislation. All the trouble, however, is not with the New York Stock Exchange, which is probably the best-regulated in the country. This may not be saying much, but it means something by comparison.

77 Cong. Rec. 3223 (emphasis added).[25] The Senator went on to discuss manipulative practices for "rigging the market." While subsequent, much-needed legislation was provided – *see* Section 9 of the 1934 Act, 15 U.S.C. § 78i – the Senator's comments did not suggest that the legislation before the Senate applied only to initial public offerings. On the contrary, he noted an intention to protect "the investor in the stock market" and that the bill proposed to place responsibility on the seller. Most importantly, the language of Section 12(2) which was finally adopted does not demonstrate a limitation to initial public offerings. *See Pacific Dunlop*, 993 F.2d at 592.

In *Pinter*, this Court reaffirmed that "[t]he ultimate question is one of congressional intent, not one of whether the Court thinks it can improve upon the statutory scheme Congress has enacted into law." 486 U.S. at 653 (quoting *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979)). Given the clarity of Section 12(2) and corresponding legislative history, the SIA's "policy considerations" are of no moment. (SIA Brief at 18-29.). *See Pacific Dunlop*, 993 F.2d at 594-595. To the extent that policy considerations are pertinent, however, "the Court has recognized that Congress had 'broad remedial goals' in

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[25] *See also Wilko v. Swan*, 346 U.S. 427, 430-31 (1953). Absent a broad interpretation of Section 12(2), secondary market purchasers would be returned to the days of *caveat emptor*. In other words, "let the seller also beware only if it is an initial public offering."

enacting the securities laws and providing civil remedies." *Pinter*, 486 U.S. at 653 (citations omitted). Securities law provisions are construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes." *Id.* (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) and *Sec. & Exch. Comm'n v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)). The remedial purposes of Section 12(2) are not furthered by restricting its application to initial public offerings.[26] While this Court has not hesitated to terminate judicially implied rights of action, *see Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, ___ U.S. ___, 114 S. Ct. 1439, 128 L. Ed. 2d 119 (1994), it should be hesitant to cut off express rights of action which would require the Court to imply a *limitation* not spelled out by Congress.

IV. CONCLUSION

The Seventh Circuit's holding in *Pacific Dunlop* should be upheld in its entirety and the Third Circuit's

[26] While it may be much more convenient to securities dealers (especially those bent on wrongdoing) to restrict Section 12(2) to primary markets, this Court, has stated that "ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress' policy decisions." *Basic Inc. v. Levinson*, 485 U.S. 224, 236 (1988).

contrary holding in *Ballay* should be overruled. The Seventh Circuit's order in this case, relying upon *Pacific Dunlop*, should be affirmed.

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Respectfully submitted,

PATRICK E. CAFFERTY
(Counsel of Record)
MILLER FAUCHER CHERTOW
CAFFERTY AND WEXLER
30 North LaSalle St.
Suite 3200
Chicago, IL 60602
Telephone: 312/782-4880

JONATHAN W. CUNEO
General Counsel
NASCAT
317 Massachusetts Avenue, N.E.
Suite 300
Washington, D.C. 20002
Telephone: 202/789-3960

Counsel for Amicus Curiae, National Association of Securities and Commercial Law Attorneys (NASCAT)